

C, who had originally contributed the machine to the partnership, has a basis for his partnership interest of \$10,000. Since section 751(b)(2)(A) provides that section 751(b)(1) does not apply to a distribution of property to the partner who contributed the property, no gain would be recognized to the partnership under section 731(b) (without regard to the application of section 1245). By reason of the application of section 731, C's basis for the property would, under section 732(b), be equal to his basis for his interest in the partnership, or \$10,000.

(ii) Since section 731 applies to the distribution, and since subparagraph (1) of this paragraph provides that, for purposes of section 1245(b)(3), C's basis for the property is deemed to be determined by reference to the adjusted basis of the property to the partnership, the gain taken into account under section 1245(a)(1) by the partnership is limited by section 1245(b)(3) so as not to exceed the amount of gain which would be recognized to the partnership if section 1245 did not apply. Accordingly, the partnership does not recognize any gain under section 1245(a)(1) upon the distribution.

(iii) Immediately after the distribution, the amount of the adjustments reflected in the adjusted basis of the property is equal to \$6,000 (that is, the potential section 1245 income of the partnership in respect of the property before the distribution, \$6,000, minus the gain recognized by the partnership under section 751(b), zero). Accordingly, C's recomputed basis for the property is \$16,000 (that is, adjusted basis, \$10,000, plus adjustments reflected in the adjusted basis, \$6,000).

*Example 2.* Assume the same facts as in example (1) except that the machine had been purchased by the partnership. Assume further that upon the distribution, the partnership recognizes \$4,000 gain as ordinary income under section 751(b). Under section 1245(b)(3), gain to be taken into account under section 1245(a)(1) by the partnership is limited to \$4,000. Immediately after the distribution, the amount of adjustments reflected in the adjusted basis of the property is \$2,000 (that is, potential section 1245 income of the partnership, \$6,000, minus gain recognized to the partnership under section 751(b), \$4,000). Thus, if the adjusted basis of the machine in the hands of C were \$11,333 (see, for example, the computation in paragraph (d)(2) of example (6) of paragraph (g) of § 1.751-1), the recomputed basis of the machine would be \$13,333 (\$11,333 plus \$2,000).

(g) [Reserved]

(h) *Timber property subject to amortization under section 194—(1) In general.* For purposes of section 1245(a)(2), in determining the recomputed basis of property with respect to which a deduction under section 194 was allowed for any

taxable year, a taxpayer shall not take into account amortization deductions claimed under section 194 to the extent such deductions are attributable to the amortizable basis (within the meaning of section 194(c)(2)) of the taxpayer acquired before the tenth taxable year preceding the taxable year in which gain with respect to the property is recognized.

(2) *Example.* The principles of paragraph (h)(1) of this section are illustrated by the following example:

*Example:* Assume A owns qualified timber property (as defined in section 194(c)(1)) with a basis of \$30,000. In 1981, A incurs \$12,000 of qualifying reforestation expenditures and elects to amortize the maximum \$10,000 of such expenses under section 194. The \$10,000 of deductions are taken during the 8-year period from 1981 to 1988. If A sells the property in 1990 for \$60,000 a gain of \$28,000 (\$60,000—adjusted basis of \$32,000) is recognized on the sale. Since the sale took place within 10 years of the taxable year in which the reforestation expenditures were made, \$10,000 of the gain is treated as ordinary income, and the remaining \$18,000 of gain would be capital gain, if it otherwise qualifies for capital gain treatment. In order to avoid ordinary income treatment of the gain attributable to the reforestation expenditures incurred in 1981, A would have to wait until 1992 to dispose of the property.

[T.D. 6832, 30 FR 8581, July 7, 1965, as amended by T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 7207, 37 FR 20799, Oct. 14, 1972; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7927, 48 FR 55851, Dec. 16, 1983]

#### § 1.1245-5 Adjustments to basis.

In order to reflect gain recognized under section 1245(a)(1), the following adjustments to the basis of property shall be made:

(a) *Property acquired in like kind exchange or involuntary conversion.* (1) If property is acquired in a transaction to which section 1245(b)(4) applies, its basis shall be determined under the rules of section 1031(d) or 1033(c).

(2) The provisions of this paragraph may be illustrated by the following example:

*Example:* Jones exchanges property A, which is section 1245 property with an adjusted basis of \$10,000, for property B, which has a fair market value of \$9,000, and property C, which has a fair market value of \$3,500, in a like kind exchange as to which no gain would be recognized under section

1031(a). Upon the exchange \$2,500 gain is recognized under section 1245(a)(1), since property C is not section 1245 property. See section 1245(b)(4). Under the rules of section 1031(d), the basis of the properties received in the exchange is \$12,500 (i.e., the basis of property transferred, \$10,000, plus the amount of gain recognized, \$2,500), of which the amount allocated to property C is \$3,500 (the fair market value thereof), and the residue, \$9,000, is allocated to property B.

(b) *Sections 1071 and 1081 transactions.*

(1) If property is acquired in a transaction to which section 1071 and paragraph (e)(1) of § 1.1245-4 (relating to limitation for section 1071 transactions, etc.) apply, its basis shall be determined in accordance with the principles of paragraph (a) of this section.

(2) If the basis of property, other than section 1245 property, is reduced pursuant to either an election under section 1071 or the application of section 1082(a)(2), then the basis of the property shall be increased to the extent of the gain recognized under section 1245(a)(1) by reason of the application of paragraph (e)(1)(iii) of § 1.1245-4.

[T.D. 6832, 30 FR 8584, July 7, 1965]

**§ 1.1245-6 Relation of section 1245 to other sections.**

(a) *General.* The provisions of section 1245 apply notwithstanding any other provision of subtitle A of the Code. Thus, unless an exception or limitation under section 1245(b) applies, gain under section 1245(a)(1) is recognized notwithstanding any contrary non-recognition provision or income characterizing provision. For example, since section 1245 overrides section 1231 (relating to property used in the trade or business), the gain recognized under section 1245(a)(1) upon a disposition will be treated as ordinary income and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. See example (2) of paragraph (b)(2) of § 1.1245-1. For effect of section 1245 on basis provisions of the Code, see § 1.1245-5.

(b) *Nonrecognition sections overridden.* The nonrecognition provisions of subtitle A of the Code which section 1245 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337,

501(a), 512(b)(5), and 1039. See section 1245(b) for the extent to which section 1245(a)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, 1033, 1071, and 1081 (b)(1) and (d)(1)(A). For limitation on amount of adjustments reflected in adjusted basis of property disposed of by an organization exempt from income taxes (within the meaning of section 501(a)), see paragraph (a)(8) of § 1.1245-2.

(c) *Normal retirement of asset in multiple asset account.* Section 1245(a)(1) does not require recognition of gain upon normal retirements of section 1245 property in a multiple asset account as long as the taxpayer's method of accounting, as described in paragraph (e)(2) of § 1.167(a)-8 (relating to accounting treatment of asset retirements), does not require recognition of such gain.

(d) *Installment method.* (1) Gain from a disposition to which section 1245(a)(1) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall be deemed to consist of gain to which section 1245(a)(1) applies until all such gain has been reported, and the remaining portion (if any) of such income shall be deemed to consist of gain to which section 1245(a)(1) does not apply. For treatment of amounts as interest on certain deferred payments, see section 483.

(2) The provisions of this paragraph may be illustrated by the following example:

*Example:* Jones contracts to sell an item of section 1245 property for \$10,000 to be paid in 10 equal payments of \$1,000 each, plus a sufficient amount of interest so that section 483 does not apply. He properly elects under section 453 to report under the installment method gain of \$2,000 to which section 1245(a)(1) applies and gain of \$1,000 to which section 1231 applies. Accordingly, \$300 of each of the first 6 installment payments and \$200 of the seventh installment payment is ordinary income under section 1245(a)(1), and \$100 of the seventh installment payment and \$300 of each of the last 3 installment payments is gain under section 1231.

(e) *Exempt income.* The fact that section 1245 provides for recognition of gain as ordinary income does not